INTERSTATE DEPARTMENT STORES, INC.

Annual Report

JANUARY 31, 1948

INTERSTATE DEPARTMENT STORES, INC.

DIRECTORS

Robert S. Adler	Will I Levy
Russell P. Bygel	Harold F. Linder
Reagan P. Connally	Benjamin W. Mayer
Charles E. Federman	Albert Parker
Paolino Gerli	S. D. Streeter
R. C. Kramer	Harold J. Szold

OFFICERS

Chairman of the Board	R. C. Kramer
President	Russell P. Bygel
Vice President	Sol W. Cantor
Vice President	Eaton B. Lloyd
Vice President	S. D. Streeter
Secretary	Albert Parker
Assistant Treasurer	Paul I. Bertram
Assistant Secretary	Edward C. Schenkel

Transfer Agent	Bank of the Manhattan Company	New York
Registrar	The Commercial National Bank and Trust Company	New York
General Counsel	Parker, Chapin and Flattau	New York
Public Accountants	S. D. Leidesdorf & Co.	New York
Executive and General Offices	111 Eighth Avenue	New York

April 26, 1948.

To the Stockholders of

INTERSTATE DEPARTMENT STORES, INC.

The Annual Report of Interstate Department Stores, Inc. and its subsidiaries for the fiscal year ended January 31, 1948 is presented herewith.

PROFITS: Profits after Federal Income Taxes for the fiscal year ended January 31, 1948, were $1,427,000 compared with $1,410,000 in 1946. These profits were equal to $4.62 per share of common stock in 1947 and $4.56 per share in 1946.

For the first half of 1947 profits were $314,000 compared with $761,000 for the first half of 1946. For the last six months, profits were $1,113,000 compared with $649,000 in 1946.

Profits were reduced in both the last half of 1946 and the first half of 1947 by a lower mark up on our merchandise and to a much greater degree by heavy markdowns. The primary cause of the heavy markdowns was the drastic changes that occurred in the character of merchandise that became available as manufacturers changed their lines from constructions necessitated by war and post-war conditions to more standard merchandise. This transition has been largely completed and unusually high markdowns from this cause should not recur.

Increase in profit resulted entirely from a decrease in income taxes. Percentage gross margin (the difference between cost of sales and actual selling price) was reduced from the previous year and was in fact the lowest since 1933. Expense expressed in percentage to sales, was slightly lower than in the preceding year, although substantial increases in wages were made during the fiscal year.

Profits for the past five years have been as follows:

Fiscal Year Ended Jan. 31	Profit Before Federal Income Tax	Provision for Federal Income Tax	Profit After Federal Income Tax
1948.......	$2,388,016	$ 961,000	$1,427,016
1947.......	2,460,069	1,050,000	1,410,069
1946.......	2,972,689	1,917,000	1,055,689
1945.......	3,668,355	2,650,000	1,018,355
1944.......	4,336,529	3,210,000	1,126,529

SALES: Total sales of $62,814,000 for the fiscal year ended January 31, 1948 were the largest in Interstate history.

Increase in our own department sales of $6,390,000 or 14% reflected not only the high rate of retail sales in 1947 but also the trend of consumers to increasingly patronize stores of our type which concentrate on the sale of essential merchandise at low prices. Contrary to the experience of many retailers in 1947, in our stores the average unit sales price declined but the number of unit sales increased 19%. While the figures are not directly comparable, the sales increase of 14% in owned retail departments compares with the Federal Reserve Board Index of Department Store Sales for the United States increase of 8%.

Sales of departments leased to others for operation increased $4,103,000 or 71%. A major part of this increase came from sales obtained by the lease of idle space in March 1947, in one of our stores to a low priced food store. This lease was made on a very low rental basis and contributes only a nominal sum directly to income. It was made primarily to aid in directing customer traffic to the location of that particular store. Since there were no sales in this department in prior years, the total sales of that department represents an increase in sales. Beginning in March 1948, when the leased food operation will have concluded a year's operation, comparative percentage increases of sales of leased departments will decline sharply from those reported in the last year.

Consolidated sales of the Company for the past five years have been as follows:

Fiscal Year Ended Jan. 31	Owned Departments	Leased Departments	Total
1948......	$52,893,521	$9,920,427	$62,813,948
1947......	46,502,752	5,817,308	52,320,060
1946......	38,995,710	5,331,954	44,327,664
1945......	37,714,356	5,195,259	42,909,615
1944......	36,541,050	5,004,155	41,545,205

INVENTORIES: Inventories after reserves were slightly less than they were last year. 95.8% of the inventory is less than one year old compared with 98.7% last year. Following the normal practice of the Company, reserves have been established against possible losses on various types of merchandise depending on their age. The inventory reserve at year end was $465,000 compared with $400,000 in the previous year. Reserves were also established for cash discounts allowed by vendors on merchandise on hand. Inventories generally are considered to be in good condition with virtually all early post-war merchadise eliminated.

Outstanding orders for delivery after February 1, 1948 totalled $4,800,000. This is equivalent to about seven weeks of sales.

WORKING CAPITAL: Working capital (the difference between current assets and current liabilities) increased $37,000 during the year.

Since profits for the year were $1,427,000 and dividend payments were $618,000,—$809,000 of earnings were retained in the business. $200,000 of these profits were used to prepay the 1948 installment of the Company's long term bank loan. $1,060,000 was spent for additions to fixed assets which after crediting $257,000 arising from depreciation charges, absorbed $803,000 of earnings and surplus.

While Interstate stores sell primarily for cash and have few charge accounts, they do sell merchandise on time payment plans for which a financing charge is paid by the customer. In 1947 a number of lines of merchandise, which are customarily sold on the basis of time payments, were introduced in additional stores. These included furniture, electrical appliances, floor coverings and allied merchandise. In addition, your stores offer customers the opportunity to buy many types of merchandise with credit coupon books which usually are paid in full within five months or less time. As a result of these factors, time payment business increased to 9.4%

of total sales in 1947, compared with 7.1% in 1946, and time payment accounts receivable at year end, were $885,000 above the previous year end. Adequate reserves have been established for possible losses from such accounts.

The continued growth in sales, the funds needed to carry the increasing volume of accounts receivable and the necessity for substantial expenditures for continued store improvements and for other fixed assets in excess of funds provided from depreciation, contribute to the necessity for adding to the Company's working capital.

The following table lists the growth of the Company's working capital for the past five years.

Fiscal Year Ended Jan. 31	Current Assets	Current Liabilities	Net Working Capital
1948......	$13,393,802	$4,691,087	$8,702,715
1947......	11,808,834	3,143,535	8,665,299
1946......	11,437,998	3,066,578	8,371,420
1945......	10,278,162	2,690,037	7,588,125
1944......	9,708,353	2,717,570	6,990,783

BUILDINGS, EQUIPMENT AND FIXTURES: Your Company spent $1,060,000 for additional improvements to its stores and properties in 1947. An additional $440,000 was charged to expense for maintenance and repairs, compared with $350,000 charged in 1946.

During the war it was not possible to make desired improvements and modernize our stores and equipment. Consequently, in following through management's plans, substantial expenditures must be made for deferred improvements and to keep the stores' appearance and facilities competitive. Charges to expense for depreciation and amortization increased $35,000 in 1947, to a total of $257,000 but cash provided by depreciation charges will not be sufficient to provide for the capital expenditures essential in 1948, which are presently estimated at $1,000,000.

Current costs of improvements, fixtures and equipment are high by pre-war standards. It is interesting to note that expenditures for fixtures, equipment, maintenance and repair in 1947, were $1,500,000 whereas the depreciated book value of all your Company's stores improvements, fixtures and equipment at the beginning of 1947 (excluding land and buildings) was $1,080,000.

FINANCING: Many factors have contributed to the conclusion reached by your Directors to seek additional capital. Among these are the following: Sales of our own operated departments have increased from $33,000,000 to $53,000,000 in the past five years. This increase in sales necessitates larger inventories than were carried formerly.

Attention has been directed earlier in this letter to the increase in accounts receivable resulting from increased time payment sales. Management believes that time payment sales will become an even more important factor in the immediate period ahead than they have been hitherto, because the Company intends to expand its sales of merchandise that is frequently bought on time payment terms. Pre-war, your Company did only a small business in such lines.

Cost of improvements to store properties and for equipment have risen sharply over pre-war costs. This increase in cost, together with the fairly substantial amount of maintenance deferred during the war by conditions beyond Management's control, will require much larger sums than the funds provided from depreciation. As mentioned above, present plans contemplate expenditures for additions to fixed assets in 1948 of approximately $1,000,000.

It is possible that attractive opportunities for expansion may present themselves in the period ahead and your Company should be in a position to capitalize on such opportunities.

Consequently, tentative arrangements were made in the summer of 1947 for the sale of a $5,000,000 debenture issue to the public. As of that time, the Company owed $1,900,000 on its long term bank loan. It expected to prepay this bank loan with the proceeds of the debenture issue and to retain $3,100,000 of additional funds.

Because of the time required for the completion of a Registration Statement with the financial audits for filing with the Securities and Exchange Commission which were necessary for a public offering, the proposed issue could not be made ready for offering to the public until the latter part of November. By that time conditions in the bond market had changed greatly and your Directors decided that the proposed plan for securing additional funds upon acceptable terms was not feasible.

Negotiations were then entered into with the Metropolitan Life Insurance Company and with banks holding your Company's long term loan notes, with the result that understandings have been reached which will satisfactorily provide for your Company's financial requirements when consummated.

The proposed insurance company loan is for the principal amount of $3,000,000, to be evidenced by the Company's 15-year note with interest at the rate of 3¾% per annum.

The bank loan agreement is to be modified to permit the proposed insurance company loan and to give the Company the right to make prepayments aggregating two years' amortization payments (instead of only one year as at present), without premium; the interest rate on the $1,900,000 of bank notes now outstanding will be 2¼% per annum.

Your attention is directed to Note B (page 11 of this Report) of the Notes to Financial Statements for a summary of the amortization provisions and the effect of the dividend restrictions of the bank loan and proposed insurance company loan agreements.

MANAGEMENT: Mr. Connally advised your Directors in 1946 that he intended to retire from full time business activity as soon as a suitable successor to him had been found. After careful consideration, Mr. Russell P. Bygel was engaged in December 1946, as Executive Vice President and elected a Director of the Company. Since that time Mr. Bygel has demonstrated the qualities the Board believes the President of your Company should have and he was elected President as of February 1, 1948. Prior to Mr. Bygel's association with Interstate, he had

been with Montgomery Ward & Co. for many years, during the last four years of which he was regional manager of that company's eastern seaboard territory, comprising 134 retail stores.

Intensive study was given to all phases of your Company's organization during the year. Three important posts have been filled, one by an experienced man from outside the Company and two from our own staff. Mr. S. D. Streeter, formerly sales manager of Montgomery Ward & Co.'s Retail Division, was elected Vice President, Store Operations Manager and Director. Mr. Sol W. Cantor who has been associated with the Company for fifteen years as a buyer, divisional merchandise manager and merchandise counselor was elected Vice President and General Merchandise Manager. Mr. Eaton B. Lloyd was elected Vice President and Sales Manager. Mr. Lloyd has been with Interstate since June 1946. Prior to his association with your Company, he was merchandise manager of Alden's and has also had extensive experience with Sears Roebuck & Co. The Proxy Committee is recommending the election of Mr. Cantor and Mr. Lloyd as Directors at the forthcoming annual meeting.

Mr. Connally retired as President on January 31, 1948, which marked the completion of ten years of service in that capacity. Mr. Connally has made an important and lasting contribution to the Company. He has greatly improved the character of the business. He worked tirelessly to train the men and women who will occupy key positions in the Company upon his retirement. The Company is fortunate that it will continue to benefit from his counsel and knowledge. It is the opinion of the Board, and a tribute to Mr. Connally, that the present organization is the ablest organization your Company has had in many years.

STORES OPENED AND CLOSED: A new Interstate store was opened in Belleville, Illinois in March 1947. A new type of store was opened in Staunton, Virginia in August 1947. New Interstate stores were opened in West Bend, Wisconsin and Port Huron, Michigan in March 1948.

As a result of studies made over a period of years, the Company during the past two years opened eight stores very much smaller than the typical Interstate store. While the results thus far have been inconclusive, it has been decided that present high costs of fixtures and equipment and changing market conditions do not warrant a continuation of that type of store at this time. Four of the small stores were discontinued in February 1948, and are being disposed of and the remaining four have become branches of existing Interstate stores in neighboring localities. The Company also discontinued the operation of a basement store in Champaign, Illinois.

DIVIDENDS: Four quarterly dividends of 50¢ each for a total of $2.00 per share on the common stock, were paid in 1947 compared with a total of $1.70 per share in 1946. The regular quarterly dividend of 50¢ per share for the first quarter of 1948 was paid on April 15th.

ASSET VALUE OF COMMON STOCK: The net asset value of the common stock of your Company as shown by the books was $30.23 per share at year end.

The net asset value for the past five years has increased as follows:

As at Jan. 31	Asset Value Per Share
1948	$30.23
1947	27.61
1946	24.74
1945	22.73
1944	20.43

ANNUAL MEETING: The Directors amended the By-laws so as to change the date of the Annual Meeting of Stockholders from the second Tuesday in May to the fourth Wednesday in May, beginning with the year 1948. This change was made in order to allow needed additional time to complete the annual audit. The meeting this year will be held May 26, 1948.

OUTLOOK: Retail activity continues at a high rate and your Company anticipates that a satisfactory volume of business will be transacted in 1948. Interstate stores sell primarily essential goods. Its policy is to sell those goods at prices at least no higher than those charged by competitors and endeavors to sell goods at prices that enable the consumers to buy the most for their money in its stores. The increases in cost of living that have occurred and the consequent necessity for consumers to have their money buy as much as possible, provides an opportunity for stores such as ours to get an increased share of the available business.

During the war and immediately thereafter, Interstate had more difficulty in buying and selling goods than the typical merchant. Its retail selling prices were low when they were "frozen" in accordance with OPA Regulations pertaining to retailers during and after the war and the supply of merchandise available to sell at those prices steadily declined. Since OPA Regulations were eliminated, the supply of merchandise for sale in our stores has gradually increased. While we cannot yet buy goods in the manner that best fits our operations, conditions are steadily improving.

Current prices for many types of merchandise are high. As production increases relative to demand, there may be some reduction in prices with some temporary increase in merchandise losses over that normally experienced. Losses arising from a lower price on standard merchandise however, are not too severe a problem for the alert merchant, and do not present the difficulties experienced between June 1946 and June 1947 when the character of merchandise changed so radically. Our business thrives best when we can continually give customers better value for their money and our increased opportunity in a declining market should at least partially compensate for such merchandise losses as may occur.

Your Company has an able, enthusiastic organization and looks forward to the opportunities ahead with confidence.

The Directors want to thank the organization for the splendid work it has performed in what was in many respect a very difficult year.

For the Board of Directors,

R. C. KRAMER, *Chairman.*

INTERSTATE DEPARTMENT STORES, INC.

AND SUBSIDIARY COMPANIES

CONSOLIDATED BALANCE SHEET AS AT JANUARY 31, 1948

ASSETS

	As at January 31, 1948		As at January 31, 1947	
Current Assets:				
Cash on hand and in banks		$ 1,353,913		$ 1,027,676
United States Treasury Savings Notes—Series C—at cost, plus accrued interest				90,291
Accounts receivable:				
Customers	$2,713,901		$1,772,045	
Less: Reserves	284,039	2,429,862	212,955	1,559,090
Other	387,372		400,469	
Less: Reserve	3,500	383,872	3,883	396,586
Merchandise inventories—(Note A)		9,226,155		8,735,191
Total Current Assets		13,393,802		11,808,834
Other Assets:				
Miscellaneous other assets, less reserves		159,107		161,635
Fixed Assets—at cost:				
Land	75,385		103,210	
Buildings			55,890	
Less: Reserve for depreciation			3,996	
			51,894	
Alterations and improvements to leased premises	559,975		218,514	
Less: Reserve for amortization	124,620		44,362	
	435,355		174,152	
Furniture and equipment	1,926,311		1,528,920	
Less: Reserve for depreciation	664,339		619,932	
	1,261,972	1,772,712	908,988	1,238,244
Leaseholds	197,882		196,529	
Less: Reserve for amortization	131,411	66,471	122,315	74,214
Deferred Charges		537,408		489,897
		$15,929,500		$13,772,824

The Notes to Financial Statements are an integral part of this statement and should be read in conjunction herewith.

INTERSTATE DEPARTMENT STORES, INC.

AND SUBSIDIARY COMPANIES

CONSOLIDATED BALANCE SHEET AS AT JANUARY 31, 1948

LIABILITIES

	As at January 31, 1948		As at January 31, 1947	
Current Liabilities:				
Accounts payable — trade creditors (including liability for merchandise in transit)		$ 2,450,797		$ 1,577,837
Accrued salaries, interest and expenses		897,927		1,093,903
Accrued Federal taxes on income—(Note C)	$1,129,101		$1,212,141	
Less: United States Treasury Savings Notes—Series C—at cost, plus accrued interest	500,000	629,101	1,212,141	—
Accrued taxes—other—(Note C)		391,132		324,954
Sundry other liabilities		322,130		96,841
Mortgage payable—due within one year		—		50,000
Total Current Liabilities		4,691,087		3,143,535
Long Term Debt:				
Notes payable—banks, due August 27, 1955—(Note B)		1,900,000		2,100,000
Total Liabilities		6,591,087		5,243,535
Capital Stock and Surplus (Note B):				
Common Stock—without par value:				
Authorized 320,000 Shares				
Issued and outstanding 308,946 Shares	1,580,252		1,580,252	
Capital Surplus (no change during year)	1,915,949		1,915,949	
Earned Surplus—per Consolidated Statement of Income and Earned Surplus	5,842,212	9,338,413	5,033,088	8,529,289
		$15,929,500		$13,772,824

The Notes to Financial Statements are an integral part of this statement and should be read in conjunction herewith.

INTERSTATE DEPARTMENT STORES, INC.

AND SUBSIDIARY COMPANIES

CONSOLIDATED STATEMENT OF INCOME AND EARNED SURPLUS FOR THE YEAR ENDED JANUARY 31, 1948

	For the Year Ended January 31, 1948		For the Year Ended January 31, 1947	
Net Sales:				
Own departments	$52,893,521		$46,502,752	
Leased departments	9,920,427	$62,813,948	5,817,308	$52,320,060
Cost of Sales, Operating and Administrative Expenses		60,230,809		49,679,784
		2,583,139		2,640,276
Less:				
Depreciation and amortization—buildings, alterations and improvements, furniture and equipment	257,350		222,819	
Amortization—leaseholds	9,096	266,446	15,195	238,014
		2,316,693		2,402,262
Other Income—Net		115,457		120,924
		2,432,150		2,523,186
Less:				
Interest paid		44,134		63,117
Net Income Before Federal Income Taxes		2,388,016		2,460,069
Provision for Federal Income Taxes		961,000		1,050,000
Net income for the year, transferred to Earned Surplus		1,427,016		1,410,069
Earned Surplus as at January 31, 1947-1946—(Note B)		5,033,088		4,148,227
		6,460,104		5,558,296
Dividends paid on Common Stock		617,892		525,208
Earned Surplus as at January 31, 1948-1947—(Note B)		$ 5,842,212		$5,033,088

The Notes to Financial Statements are an integral part of this statement and should be read in conjunction herewith.

NOTES TO FINANCIAL STATEMENTS
AS AT JANUARY 31, 1948

NOTE A—Merchandise inventories, as at January 31, 1948, which include merchandise in transit in the amount of $570,289, are stated on the following bases which are consistent with those used in the preceding year:

At Stores —At the lower of cost or market, as calculated by the retail method of inventory pricing, after provision for markdowns based on age of merchandise.

At Warehouses—At the lower of cost (substantially on the "First in, First out," basis) or replacement market.

In Transit —At specific invoice cost.

NOTE B—The bank loan agreement contains certain restrictions on the right of the Company to declare dividends (other than stock dividends) and requires amortization payments as follows: $200,000 per annum for the next six years and the balance of $700,000 at maturity of the bank notes on August 27, 1955. These payments are due on August 27th of each year. The payment due August 27, 1948 was paid in advance, with the result that no installment is due until 1949.

The Company is arranging to borrow $3,000,000 from the Metropolitan Life Insurance Company, payable over a period of fifteen years with interest at the rate of 3¾% per annum. It is contemplated that the insurance company loan agreement will require amortization payments as follows: $75,000 per annum until 1955, $200,000 per annum from 1956 through 1958, $325,000 in 1959, $350,000 per annum from 1960 through 1962, and $500,000 in 1963. The proposed insurance company loan agreement also contains restrictions on the right of the Company to declare dividends (other than stock dividends), including a requirement that the Company have certain ratios (of consolidated net current assets and of consolidated net tangible assets to consolidated funded debt) after payment of such dividends.

As at January 31, 1948, $300,000 of the Company's surplus would not be subject to the dividend restrictions contained in the loan agreements referred to above. The amount available for dividends would be increased or decreased primarily to the extent that future consolidated net income is in excess of or less than the aggregate amounts of dividends paid or declared subsequent to January 31, 1948 and would be decreased by the excess over an aggregate of $500,000 invested in and advanced to certain subsidiaries which may hereafter be organized (defined as Unrestricted Subsidiaries in the proposed insurance company loan agreement).

NOTE C—The accompanying financial statements are subject to final determination of Federal, state and local taxes. The Federal income and excess profits tax returns have been examined through the fiscal year ended January 31, 1944 and all additional assessments thereon have been paid.

INTERSTATE DEPARTMENT STORES, INC.

AND SUBSIDIARY COMPANIES

ACCOUNTANTS' REPORT

To the Board of Directors,
INTERSTATE DEPARTMENT STORES, INC.,
New York, N. Y.

We have examined the consolidated balance sheet of Interstate Department Stores, Inc. and subsidiary companies as at January 31, 1948 and the consolidated statement of income and earned surplus for the year then ended; have reviewed the system of internal control and accounting procedures of the companies and, without making a detailed audit of the transactions, have examined or tested accounting records of the companies and other supporting evidence by methods and to the extent we deemed appropriate. Our examination was made in accordance with generally accepted auditing standards applicable in the circumstances and included all procedures which we considered necessary.

Our examination of the merchandise inventories included a general review of the inventory procedures and records, including the retail inventory records, and tests to determine the mathematical accuracy of the inventory schedules. In addition, our representatives were present at the Company's principal warehouse as well as at certain stores, which we considered to be representative and which we selected for test purposes, to determine that the inventory procedures were carried out effectively and to make tests of the quantities in the inventory. We also communicated directly with vendors who are holding Company's merchandise pending delivery instructions from the Company. Our examination of the customers' accounts receivable included tests by direct communication with a selected number of customers at stores selected by us.

In our opinion, the accompanying consolidated balance sheet and related consolidated statement of income and earned surplus, together with the notes to financial statements, present fairly the consolidated position of Interstate Department Stores, Inc. and subsidiary companies at January 31, 1948 and the consolidated results of their operations for the year, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

S. D. Leidesdorf & Co.

New York, N. Y.
April 19, 1948.